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INTERNATIONAL COOPERATION IN TAX MATTERS

Work of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

Report of the Secretary-General

SUMMARY

The present report contains a brief account of the discussions of the Ad Hoc Group of Experts on International Cooperation in Tax Matters at its 6th meeting. A set of recommendations made by the Ad Hoc Group was directed to the tax administrations of developed and developing countries to enable them to enhance the formulation and working of double taxation conventions, maximize tax compliance, improve tax equity, minimize the cost of tax collection, decrease and/or eliminate tax evasion and avoidance and promote international cooperation in tax matters (see paras. 5, 6, 9, 10, 11-16, 25, 33 and 37 of the report. Attention is drawn to paragraphs 17, 18, 19 and especially paragraph 40 in which the Group considered the possibility of holding their meeting annually instead of biennially.

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INTRODUCTION

1. The present report has been prepared pursuant to Economic and Social Council resolutions 1980/13 of 28 April 1980 and 1982/45 of 27 July 1982 in which the Council requested the Secretary-General to report on the progress of the Ad Hoc Group of Experts on International Cooperation in Tax Matters at the session following each meeting of the Group.

2. The resolutions referred to above also defined the terms of reference 1/ of the Ad Hoc Group, to include the following:

(a) Development or formulation of guidelines for international cooperation to combat tax evasion and avoidance;

(b) Examination, on a continuous basis, of the United Nations Model Double Taxation Convention between Developed and Developing Countries and consideration of the experience of countries in bilateral application of that Convention;

(c) Study, on a continuing basis, of the possibilities of enhancing the efficiency of tax administrations and formulation of appropriate policy and methodology suggestions;

(d) Study of the possibilities of reducing potential conflicts among the tax laws of various countries and the methods for reaching acceptable compromises.

3. The 6th meeting of the Ad Hoc Group was held at the Palais des Nations in Geneva from 11 to 17 December 1991.

4. The Group discussed issues contained in the following rearranged substantive agenda items:

1. Procedures process and modalities for the exchange of information;

2. Problems arising out of the taxation of income from the transfer of technology, including patents and other forms of intellectual property, the provision of technical services and related topics;

3. Impact of the United Nations Model Double Taxation Convention between Developed and Developing Countries;

4. Work of the Group at its 7th meeting;

5. Other matters.

I. EXCHANGE OF TAX INFORMATION

A. Role of information exchange in overall treaty programmes

5. The Group agreed consensually that the exchange of information was one of the most critical factors influencing the effectiveness of tax treaties and in developing and maintaining meaningful cooperation between contracting States. In their view, the administrative burdens implied by the process of exchange appeared to have been outweighed by the gains flowing from the enhancement of the mutual interests of the contracting States. To substantiate that view, the Group cited examples of significant revenue gains derived from the use of the mechanism of exchange.

B. General objectives of information exchange

6. The Group enumerated the following general objectives of the exchange of information:

(a) To facilitate the implementation of tax treaties for the avoidance of double taxation and the prevention of treaty abuse;

(b) To enhance the transparency of tax accounting done by the taxpayer and/or his agent;

(c) To combat tax avoidance and evasion;

(d) To enable the tax authorities to administer more effectively the taxes covered by the tax treaty.

7. The issues which the Group considered as critical in achieving improved and efficient exchange of information between developed and developing countries included the scope, procedures, limitations and use of information. As regards taxpayers' rights, the Group noted the importance of achieving confidentiality of information and of ensuring that its use was restricted to the purposes for which the law and treaty provided.

C. Scope

8. In general, the taxes covered by the exchange of information were restricted to those which were the subject of the relevant convention. Some members of the Group indicated that the exchange of information could be usefully extended, in so far as domestic law could be extended by treaty, to include other forms of taxation - for example, not only value-added taxes but also capital taxes and taxes on capital transfers. The Group also noted that both the Organisation for Economic Cooperation for Development (OECD) and the United Nations Model Double Taxation Convention did not request information that was limited to residents of either State.

9. The Group considered that, if the process of exchange of information were to be fully effective:

(a) The requested State should be required to provide information access in cases in which it had no tax interest in the information requested;

(b) Exchanges should apply to non-criminal cases and, to the maximum extent possible, under internal law, to criminal matters in relation to fiscal offenses.

10. In that connection, the Group agreed that the question of assistance in the collection of taxes of a treaty partner was inherently different from the process of information exchange since it involved actual assistance in carrying out the tax administration functions of the other States. In light of that, the Group decided that the question should be deferred for discussion at some future date.

D. Procedures

11. To ensure the effectiveness of the exchange of information process, the Group agreed, among other things, that the competent authorities should, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information should be made, including, where appropriate, exchanges of information regarding tax avoidance.

E. Methods of exchange of information

12. The Group agreed that the methods of exchange of information in use included routine or automatic exchanges, requests for specific information and information on the discretionary initiative of the contracting State (that is, spontaneous exchange).

F. Other aspects of exchange of information

13. The Group was informed of the experience of a developed country concerning two aspects of the exchange of information - namely, simultaneous examinations and industry-wide 2/ exchanges.

G. Factors to be considered by the requesting State

14. The Group indicated that the following factors should be considered by the requesting State:

(a) The provision of specific details to facilitate the identification of the taxpayer and the assurance that a bona fide tax case was being pursued;

(b) A clear statement of the reason or reasons for specific request;

(c) A statement of the manner in which the information was to be utilized;

(d) An indication of the language or languages in which the information was to be furnished;

(e) An assurance that it had exhausted its own administrative processes and possibilities before making the request;

(f) When the information was needed for judicial proceedings or other proceedings, a clear indication of the form of the document and the appropriate authentication required with respect to that document.

H. Factors to be considered by the requested State

15. The Group also agreed that the following factors should be considered by the requested State:

(a) Its administrative capability to furnish the information requested, considering the terms set by the requesting State. In the event that the requested State was unable to comply with the request, it should convey to the requesting State its reason or reason(s) for not being able to meet the request;

(b) The terms under which, subject to its domestic laws or other reasons, it was supplying the information;

(c) The requested State should use its best endeavours to facilitate expeditious compliance with the request for information;

(d) The requested State should determine whether to inform the taxpayer concerned of the proposed exchange of information;

(e) The requested State should assure itself that the requesting State would use the information in accordance with the provisions of the treaty and observe the appropriate confidentiality standards.

I. Other matters to be considered in the course of treaty negotiations

16. Finally, the Group agreed that the following matters should also be considered in the course of treaty negotiations:

(a) The limitations imposed by law and practice on the exchange of information by the contracting States, including the statutory limitations affecting the assessment and collection of tax;

(b) The revenue level at which it would be considered cost-effective to engage in the exchange of information in question;

(c) The official channels of communication for the exchange of information;

(d) Determination of the extent to which there would be cost-sharing or cost-reimbursement with respect to the process of the exchange of information;

(e) The legal and administrative rules and regulations governing the exchange of information;

(f) The obligation of the requesting State to honour the secrecy of the information received. In that regard, the contracting States should indicate clearly the persons to whom the requested information can be disclosed;

(g) In the case of specific requests, the availability of the right of appeal to the taxpayer concerned.

J. Future work of the Ad Hoc Group on the exchange of information

17. The Group considered its future work on the exchange of information and concluded that it should continue to promote awareness of the importance of developing a network of comprehensive double taxation treaties. The Group reaffirmed the fundamental importance of enhanced operation of the exchange of information provisions so as to improve the effectiveness of tax administration in relation to international tax matters. To that end, the Group proposed the following practical steps:

(a) As regards the organizational structure of tax administrations, a questionnaire would be issued, designed to establish current arrangements throughout member States and to help to determine a model structure embodying the basic elements of an efficient and effective international tax administration. The model would be made available to member States upon request;

(b) As regards training, the Group agreed that its role should be to act as a catalyst in promoting an awareness of the importance of exchange of information to enhance the effectiveness of tax administration in developing countries. The focus of the training effort should be twofold: first, to develop the organizational capability to handle international tax, including the affairs of transnational and multinational enterprises; and secondly, to alert case officers to the factors which indicated that either a request for information or the spontaneous transmission of information could be worthwhile in a particular case.

18. In order to fulfil that role, the Group decided:

(a) That it was appropriate to concentrate on coordinating the training activities of existing national, regional and other groups of tax administrators and on bringing those activities to the notice of those United Nations Member States that were not also members of one of those groupings. The Group considered, however, that they might contribute directly to the training effort of those other organizations by seeking to identify aspects of the exchange of information which merited inclusion in the syllabus and making those aspects available through the medium of appropriate organizations. 3/ The Group suggested an outline of the syllabus, drawing particularly on sections G, H and I of its report on its 6th meeting. The suggested syllabus was attached to the report as annex I;

(b) To explore with the appropriate organizations whether joint seminars might be run for the benefit of those already concerned with training programmes so as to introduce the Group's suggested syllabus on exchange of information and to train the trainers in its use.

19. As regards dissemination of information for the benefit of member States, the Group considered that the Secretariat might, subject to the approval of the Economic and Social Council, serve as a clearing-house for information concerning the availability of technical assistance, including training courses. In order to support the process of dissemination, it was proposed to set up an information source consisting of administrative rulings, the anonymized outcome of mutual assistance proceedings and important court cases bearing on international double taxation issues.

20. In annex II to its report, the Group provided practical examples of the type of information about availability of technical assistance which it judged relevant and deserving of dissemination to member countries in a structured way.

21. Finally, the Group made reference to the United Nations publication Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries 4/ and considered whether it was a suitable medium for disseminating and applying the exchange of information article. The Group concluded that, while an opportunity should be taken to incorporate its latest thinking on the subject when the guidelines were next revised, bringing out a new edition was not a priority item at the current time, given other demands on resources.

II. PROBLEMS ARISING OUT OF THE TAXATION OF INCOME FROM THE TRANSFER OF TECHNOLOGY

22. The Group discussed the nature of income arising from the transfer of technology and the nature of tax treatment given to that income in double taxation treaties in the context of the contrasting provision contained in OECD and United Nations Model Double Taxation Convention.

23. The Group recognized the difficulties experienced by contracting States in arriving at a widely acceptable definition of royalties, especially as it

related to the distinction between the consideration (payments) for information concerning industrial, commercial or scientific experience and payments made for technical services. Varying positions were outlined during the deliberations.

24. The Group discussed the basis for the taxation of royalties. The recognition of expenditure incurred by the transfer of technology as a factor affecting the rate of withholding tax on gross income was discussed by the Group. In practice, the suppliers of the technology, in fixing the amount of the royalty, might take account of the withholding tax in the source country so that the user would pay more for the use of the technology than he would if the withholding tax levied by the developing country were lower. As regards the State, the result would be reduced revenue due to the increase in expenses deducted and a greater outflow of scarce foreign exchange.

25. The Group agreed that the determination of an appropriate withholding tax rate on gross income was a difficult and complex matter. The Group also considered that, although the expenses constituted an important element in the determination of the rate of taxation, other factors, including the following, should be taken into account if a proper balance of interest was to be achieved:

(a) The need of the developing country to earn revenue and conserve foreign exchange;

(b) The fact that royalty payments flowed in the main from the developing countries to the technology-exporting developed countries;

(c) The importance of avoiding a shift of the tax burden towards the developing country;

(d) The costs of, and risks involved in, the development of technology;

(e) The relative importance of the revenue foregone in the process of economic development.

26. In the ensuing discussions of the Group, a view emerged that in determining the withholding tax rates applicable to gross income, it would be prudent to consider fixing the rate at such a level as would result in taxation at a level equivalent (as far as possible) to that obtained by applying the relevant standard income tax rates to net income. That objective, if achieved, would in some measure serve to ensure the credibility of taxes in the residence country.

27. The Group recognized that the compromises identified in the course of their discussions and which were embodied in their report had their origins in specific tax treaties and commended them for study by treaty negotiators. It was the sense of the Group that, in view of all the varying circumstances confronting treaty negotiators, an appropriate balance of interest could only be achieved if a mutually acceptable approach was adopted in bilateral tax

relations. It was the consensus of the Group that such relations could be facilitated through the enhancement of the exchange of information process.

III. IMPACT OF THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION

28. The Group discussed the United Nations Model Double Taxation Convention under two headings - namely, the force of attraction rule, and the taxation of dividends, branch profits and interest. (The taxation of royalties was dealt with under the heading "Problems arising out of the taxation of income from the transfer of technology".)

29. The Group focused its discussion concerning the impact of the force of attraction rule (set out in para. 1 of art. 7 of the Convention) on the influence of the rule on the process of treaty negotiations and the effect of its application in practice. The discussion was marked by a divergence of views between members from developed and developing countries.

30. The Group nevertheless concluded that, for the purpose of protecting the interests of the host State in the taxation of business profits, while not constraining the freedom of enterprises to determine on commercial criteria the respective roles of head offices and permanent establishments, the limited force of attraction rule should remain unamended. As a practical matter, treaty negotiators should be encouraged to discuss on a case-by-case basis the way in which the anti-abuse provision ("merchandise of the same or similar kind") should be applied and seek to agree to the appropriate criteria in the course of negotiating treaties. In applying the treaties subsequently, maximum use should be made of the exchange of information provision (art. 26) and, to resolve disputes, of the mutual assistance procedure (art. 25). The Group further decided that, to assist treaty negotiators in those tasks, it would be helpful to assemble and publish a stock of practical examples of cases where the force of attraction rule had been found to be in point. Such a list of summarized cases should also extend to the operation of any alternative anti-abuse provision adopted by those member States whose treaties did not include a force of attraction rule. In addition to actual cases, members were also invited to submit theoretical problems, together with suggested solutions. The discussion had served to show that no single set of generalized interpretative guidance was either possible or desirable. However, reference to a couple of settled cases and theoretical examples should serve to ensure better informed negotiation of, and subsequent application of, the business profits article in future.

31. With regard to the tax treatment of dividends, the main issues considered included the source country's right to taxation, the level of withholding taxes, the taxation of intercompany dividends, the tax rates applicable to direct (as distinct from portfolio) investment, the future treatment of certain new forms of financial instruments and the taxation of branch profits. The Group recognized the right to tax of the State of which the company paying the dividends was a resident as well as the State in which the beneficial owner of the dividends was resident.

32. In general, however, most countries imposed a tax on foreign source dividends. The issue which engaged greatest attention was the level of the rates of withholding tax. The developed countries, especially those exempting intercompany dividends from tax, favoured relatively low rates of tax, in contrast to developing countries, where revenue considerations were critical. There was a general agreement, however, that while revenue considerations were important, it was worthwhile, in the context of facilitating the flow of investment capital, to determine the tax at rates which would generate an overall tax level roughly equivalent to that which should ensure the creditability of the source country's tax, including underlying tax, where appropriate. Whatever the structure of the corporate tax system, the important thing was to set a tax rate that would not discourage investment flows.

33. It was noted by the experts from developing countries that in the future, treaties in the interest of developing countries seeking to attract investment capital would be enhanced if developed countries not exempting foreign source dividends from tax would extend that exemption to incentive-enjoying company dividends from developing countries instead of granting tax-sparing credits.

34. In relation to the taxation of branch profits, it was stated that in general, developing countries were not opposed to the principle of branch profits taxation, even if they did not impose branch profits tax. Members of the Group discussed aspects of taxation of branch profits. In conclusion, attention was drawn to the fact that in treaties providing for tax on branch profits, a potential conflict with the non-discrimination article could arise. Since, in most systems that impose a branch tax, the tax represented a second level of tax on the profits of the foreign corporation that was not imposed on a domestic corporation carrying on the same activities, it could be viewed as a technical matter, as prohibited by paragraph 4 of article 24 (Non-discrimination) of the United Nations Model. However, those countries that imposed the tax did so as an analogue to the dividend withholding tax paid on a dividend from a subsidiary to its foreign parent. They, therefore, saw it as an appropriate form of discrimination and included in the non-discrimination article an explicit exception allowing the imposition of the branch tax.

35. As concerned the taxation of interest, the issue was the level of withholding tax that would, as in the case of the income from the transfer of technology, facilitate the creditability of the same country's tax.

36. When the question of thin capitalization was raised as creating difficulties for developing countries, it was explained that the matter was dealt with in the report of the 4th meeting of the Ad Hoc Group, Contributions to International Cooperation in Tax Matters. 5/

37. As a footnote to the discussions on dividends and interest, the attention of the Group was drawn to recent developments in the financial markets in which new financial instruments, as designed, were able to take advantage of unintended benefits under the tax systems they were being issued. It was

decided that the Group should give further consideration to that matter at its next meeting.

IV. FUTURE WORK OF THE GROUP

38. The Group decided that the following topics would be discussed at its 7th meeting:

(a) Transfer pricing, in particular as it relates to pricing of primary products between related entities, cost-sharing arrangements and the provision of services;

(b) The tax treatment of new financial instruments (hybrid instruments);

(c) Tax treatment of students and teachers.

39. Members were requested to submit papers or notes on the three topics to the Fiscal and Financial Branch, Department of International Economic and Social Affairs, United Nations, no later than January 1993, so that they might be used by the preparatory subgroup at its June 1993 meeting to prepare the working paper for the 7th meeting of the Group in December 1993.

V. OTHER MATTERS

40. Members of Group recommended that the meeting of the Group should be held annually instead of biennially, because the rapid rate with which changes were taking place in the field of international taxation issues, bearing on the globalization and regional integration of the world economy, was such that even a yearly meeting of 14 days duration would be insufficient for discussion and consideration of important developments. Some members pointed out that the Fiscal Affairs Committee of OECD, which covers only 21 countries, met two to three times yearly to consider international tax issues.

Notes

1/ For a detailed elaboration of the terms of reference of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, see the Report of the Secretary-General, United Nations document E/1990/49, 11 April 1990, pp. 6-7.

2/ "Industry-wide" means exchange of information by economic sector.

3/ For example, the Committee of Executive Secretaries of Tax Organizations (CESTO).

4/ United Nations publication, Sales No. E/F/S.79.XVI.3.

5/ Ibid., Sales No. E/F/S.88.XVI.1.